Executive Office for Administration and Finance

POLICY BRIEF SERIES

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Impacts of a Capital Gains Tax Increase

Executive Summary

In 1994, the Massachusetts Legislature, at the behest of Governor Weld and Lieutenant Governor Cellucci, enacted an innovative long-term capital gains tax reduction that not only reduced the tax rate, but rewarded patient investing by lowering the rate one percentage point for each year an investor held an asset. Since the enactment of this reduction, Massachusetts has experienced sustained economic growth, outpacing even the rapid growth of the nation as a whole. **Unfortunately, both Houses of the Legislature have included in their final budget bills a repeal of the last phase of the capital gains tax reduction, increasing the rate on investors who hold assets for more than five years.**

Increases in capital gains taxes rarely increase revenues. Yet they do punish patient investment, which is the only sure method of raising productivity and wages. The Legislature's proposal to renege on the capital gains tax reduction passed two years ago will discourage investment, depress wages, and possibly even reduce state revenues. This policy reversal is flawed and should be abandoned by the Legislature for the following reasons:

- It punishes the investors most likely to augment economic growth due to their long-term perspective, and many may well be aged residents drawing down their lifetime savings in retirement.
- Nine out of the last ten changes in the capital gains tax rate at both the State and the Federal level have resulted in revenues moving in the opposite direction of the rate change. Given the history of capital gains tax changes, assuming increased state revenue from capital gains tax increases is a risky conjecture and could lead to less revenue to support greater spending.
- Higher taxes on capital gains also discourage and distort investment, which has been the primary driver of our current economic expansion.
- Investment is also the only sure way to increase productivity, which is the only way to increase wages over the long-term.
- Taxes are among the most influential factors influencing investment location decisions, and capital can move very quickly from state to state and country to country in today's global economy.
- Reversing a tax reduction before it is fully implemented will erode confidence in past and future Legislative overtures to the business community, making them far less effective in the future.
- Even with our recent reductions in the capital gains tax rate, Massachusetts still has higher taxes on capital gains and investment earnings than most of our competitors. Increasing them more will make the state less attractive to capital investment and punish Massachusetts workers and families.

Impacts of a Capital Gains Tax Increase

In 1994, the Massachusetts Legislature, at the behest of Governor Weld and Lieutenant Governor Cellucci, enacted an innovative long-term capital gains tax reduction that not only reduced the tax rate, but rewarded patient investing by lowering the rate one percentage point for each year an investor held an asset. Ultimately, investors would pay no tax on capital gains provided they had invested for at least six years. Such an incentive for long-term investing sought to attract capital and entrepreneurs focused on increasing the absolute value of their assets as opposed to those seeking simply a speculative return.

Since the enactment of this reduction, Massachusetts has experienced sustained economic growth, outpacing even the rapid growth of the nation as a whole. Despite the decrease in the tax rate, capital gains tax revenues have increased at an astounding pace of 31% per annum. Many factors have contributed to the success of the Massachusetts economy, but data strongly suggests that the reductions in the capital gains tax rates, at both the state and the Federal level, are important factors in Massachusetts' prosperity.

Unfortunately, both Houses of the Legislature have included in their final budget bills a repeal of the last phase of the capital gains tax reduction, increasing the rate on investors who hold assets for more than five years. Paradoxically, these are the investors most likely to augment economic growth due to their long-term perspective, and many may well be aged residents drawing down their lifetime savings in retirement.

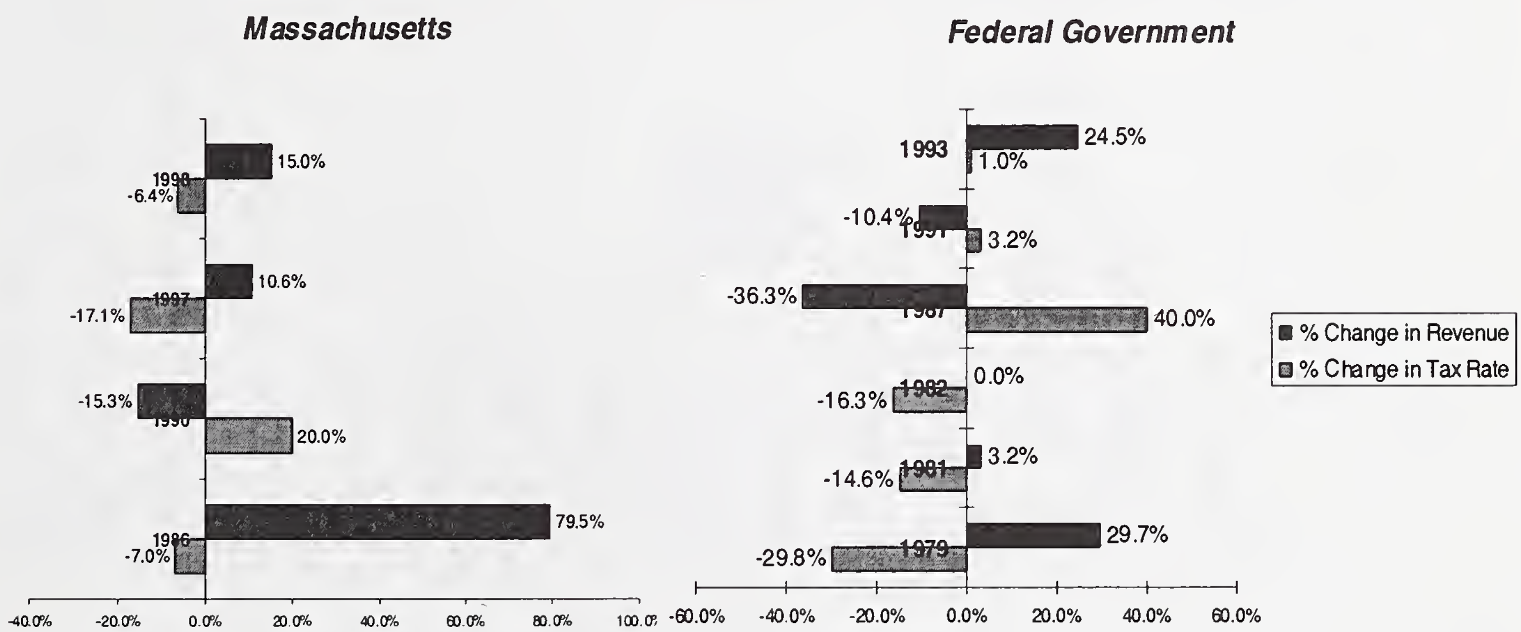
Length of Time Asset is Held	Current Law	Legislature's Proposal
Less than One Year	12%	12%
1 to 2 Years	5%	5%
2 to 3 Years	4%	4%
3 to 4 Years	3%	3%
4 to 5 Years	2%	2%
5 to 6 Years	1%	2%
More than 6 Years	0%	2%

This report will analyze the effects of capital gains taxes along several parameters:
- State Revenues
- Overall Economic Growth
- Wages
- Capital Mobility
- State Competitiveness

Revenues
The Department of Revenue's "static" projections of the revenue impact of the proposed tax increase indicate that it will raise between $100 million and $150 million when fully

implemented. But the Department caveats this projection by noting its models fail to account for changes in investment behavior and are therefore "uncertain." Such changes in behavior have resulted in vastly different impacts following past changes in the capital gains tax rates. **Over the past twenty years, four out of the five increases in the Federal or State capital gains tax rate have resulted in decreased collections and five out of five decreases in capital gains tax rates have resulted in increased collections.** Official data is not yet available for the more than 30% reduction in the Federal rate in 1997, but revenues are almost certain to have increased dramatically since then. A report from Standard & Poor's DRI predicted that the 1997 reduction would account for $80 billion in GDP growth and $8 billion in increased Federal receipts between 1998 and 2002.[1] A more recent report confirmed this prediction.[2]

Percent Change in Capital Gains Tax Rate Vs. Percent Change in Capital Gains Tax Collections



Source: Dept. of Revenue, Internal Revenue Service

While many factors, such as the current dramatic rise in the stock market, contribute to changes in capital gains collections, those factors are not completely independent of the tax rate.[3] The 1987 increase in the Federal capital gains tax rate was followed by slow growth in the market and declining capital gains collections, despite a continuing economic expansion. Dramatic gains in the market and significant increases in collections have accompanied the 1997 decrease in the Federal tax rate, even though the economic expansion was five years old at the time of enactment. In fact, the pace of the economic expansion has quickened since the capital gains tax rate cut. A Standard & Poor's DRI report estimates that 25% of the increase in the stock market is the result of the reduction in Federal capital gains taxes.[4]

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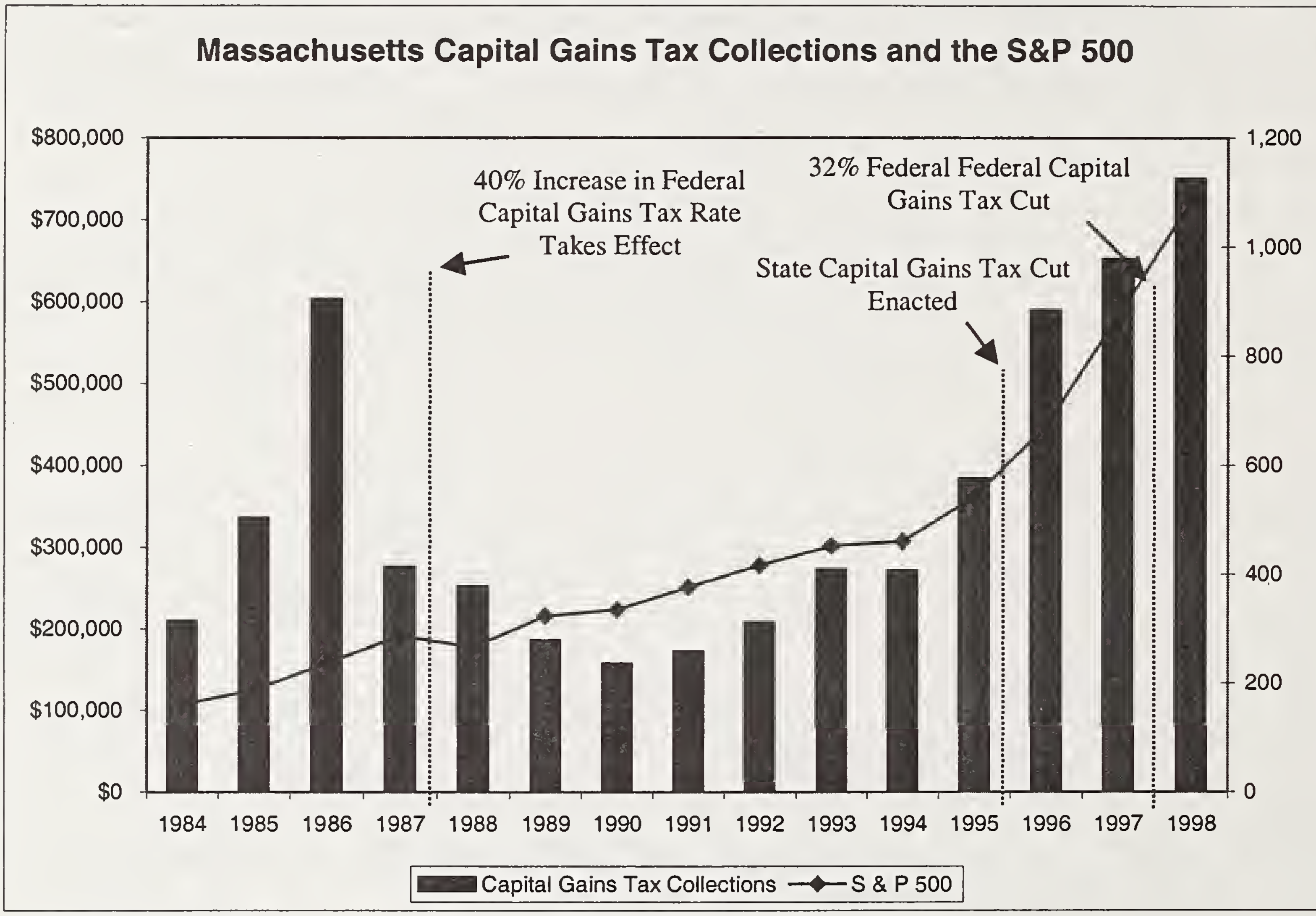
[1] Testimony before the US House Ways and Means Committee from the American Council for Capital Formation, March 1997

[2] "Capital Gains Taxes and the Economy: A Retrospective Look" David Wyss, Standard & Poor's DRI

[3] "Capitalization of Capital Gains Taxes: Evidence from Stock Price Reactions to the 1997 Rate Reduction" Mark H. Lang, Douglas A. Shackelford

[4] "Capital Gains Taxes and the Economy: A Retrospective Look" David Wyss, Standard & Poor's DRI

Given the history of capital gains tax changes, assuming increased state revenue from capital gains tax increases is a risky conjecture. Data does not prove that an increase in the capital gains tax will decrease revenue, but it does provide enough examples of just that occurrence to warrant caution in making use of any anticipated revenue increase linked to a rise in the capital gains tax rate. Detailed analysis of the



Source: Dept. of Revenue

1997 Federal capital gains tax reduction by Standard & Poor's DRI suggests this 30% reduction was "roughly revenue-neutral."[5] The proposed tax increase should at best be equally inconsequential to the tax revenue of the Commonwealth.

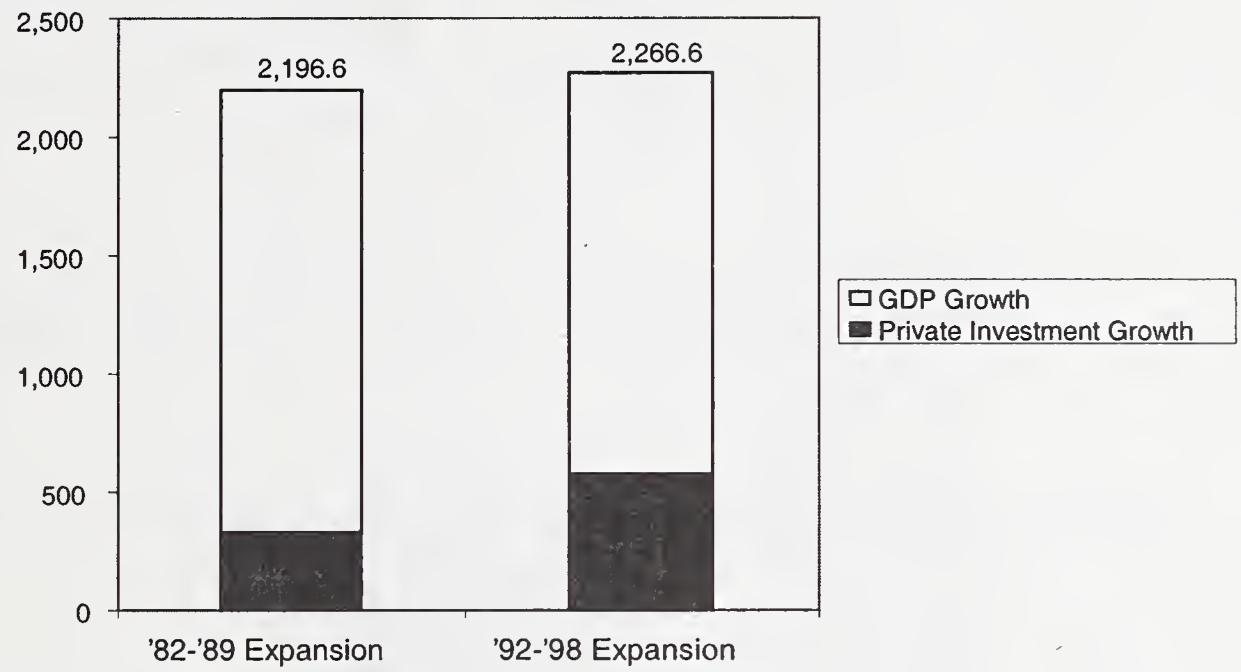
Economic Growth

While the effect of capital gains tax rate increases on revenue has historically been negative, **higher taxes on capital gains also discourage and distort investment.** As Professor Michael Porter of Harvard has noted, capital gains taxes hinder the efficiency of the capital markets and decrease incentives for both individuals and corporations to invest.[6] This is because capital gains taxes do not only reduce an investor's after-tax

[5] "Capital Gains Taxes and the Economy: A Retrospective Look" David Wyss, Standard & Poor's DRI
[6] Testimony of Michael E. Porter, Tax Equity Alliance v. M. Adams, 1995

return, they also discourage corporations from retaining earnings, which is the most effective way to finance business growth. Given the greater role investment plays in driving economic growth, a capital gains tax rate that discourages investment is the exactly wrong policy for the future.

Private Investment Growth Versus Total GDP Growth
$ Billions

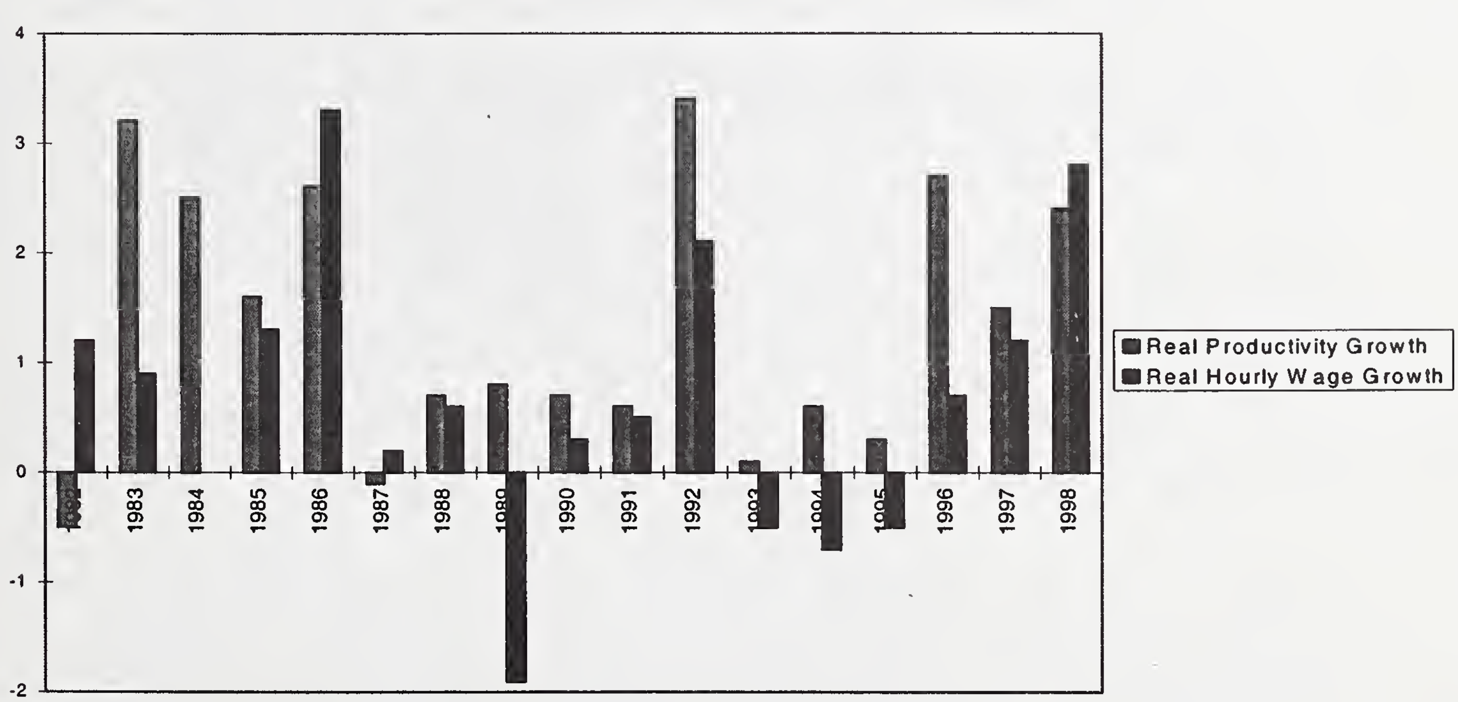


Source: Bureau of Economic Analysis

Wage Impact

Investment is also the only sure way to increase productivity, which is the only way to increase wages over the long-term. The increased levels of investment and productivity

Wage and Productivity Growth



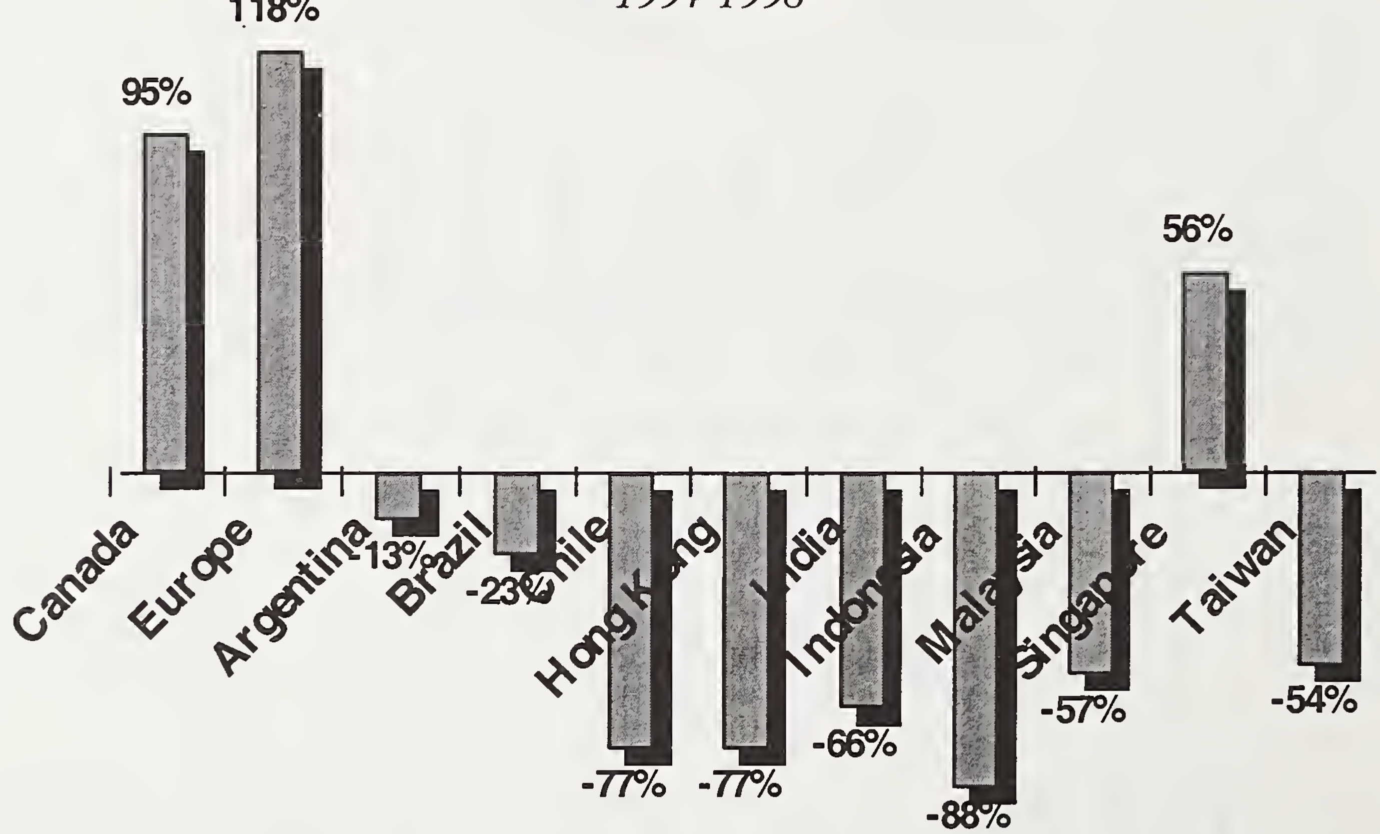
Source: Bureau of Economic Analysis

during the recent expansion are one of the major reasons average hourly wages have risen in recent years. As the chart above indicates, only during periods of sustained productivity growth do wages rise consistently. Increased private domestic investment is the chief reason we have experienced higher productivity growth in recent years. These relationships have been proven empirically. As Jason Cummins of NYU pointed out in his study of multi-national corporations, **a drop in the after-tax cost of capital results in "robust investment, which translates directly into productivity gains."**[7] Austan Goolsbee's analysis of the farming, mining, and construction machinery industries suggests taxes on capital reduce the quality as well as the quantity of investment.[8]

Capital Mobility
In today's market, attracting capital is essential to raising productivity and wages, whether it is within countries, regions or states. Massachusetts has been very successful in attracting capital in the past, but as countries throughout the world have discovered, capital can move across borders very quickly.

Percent Change in Direct US Investment in Selected Countries

1994-1998

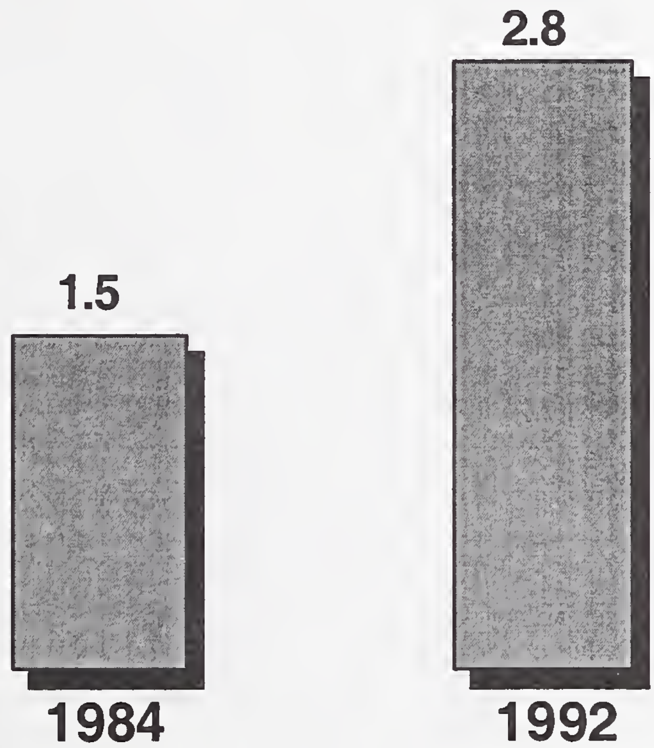


Source: Bureau of Economic Analysis

[7] "Taxation and the Sources of Growth: Estimates from United States Multinational Corporations" Jason Cummins
[8] "Taxes and the Quality of Capital" Austan Goolsbee

Tax rates are among the most important factors influencing capital movement. A report published by the National Bureau of Economic Research in 1998 shows that the sensitivity of capital to taxes on a global scale is large and growing.[9] In 1984, a country whose tax policy decreased investment returns by 1% would drive down investment from US corporations by 1.5%; by 1992, the effect had almost doubled. This is not surprising given the increasing globalization of the world's economies. A second report published the same year indicates that this result should be even more pronounced within national boundaries.[10]

Tax Elasticity for US Capital Investment Abroad



Source: National Bureau of Economic Research

While there is limited data on the subject within the United States, Massachusetts should be among the most sensitive states to increases in capital gains taxes. For instance, the study by Standard & Poor's DRI for the American Council for Capital Formation concluded that capital gains taxes are among the important factors in influencing the creation of high-tech start-ups.[11] Not only do they tax the financial capital so critical for start-up industries; capital gains taxes are also taxes on the skilled labor essential for the high-tech industry. This is because many of the most highly skilled employees in the high-tech sector receive most of their compensation as equity in the company. Given the leadership position Massachusetts has in the high-tech sector, capital gains tax increases should be a particular burden for the state.

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9 "Has U.S. Investment Abroad Become More Sensitive to Tax Rates?" Roseanne Altshuler, Harry Grubert, T. Scott Newlon

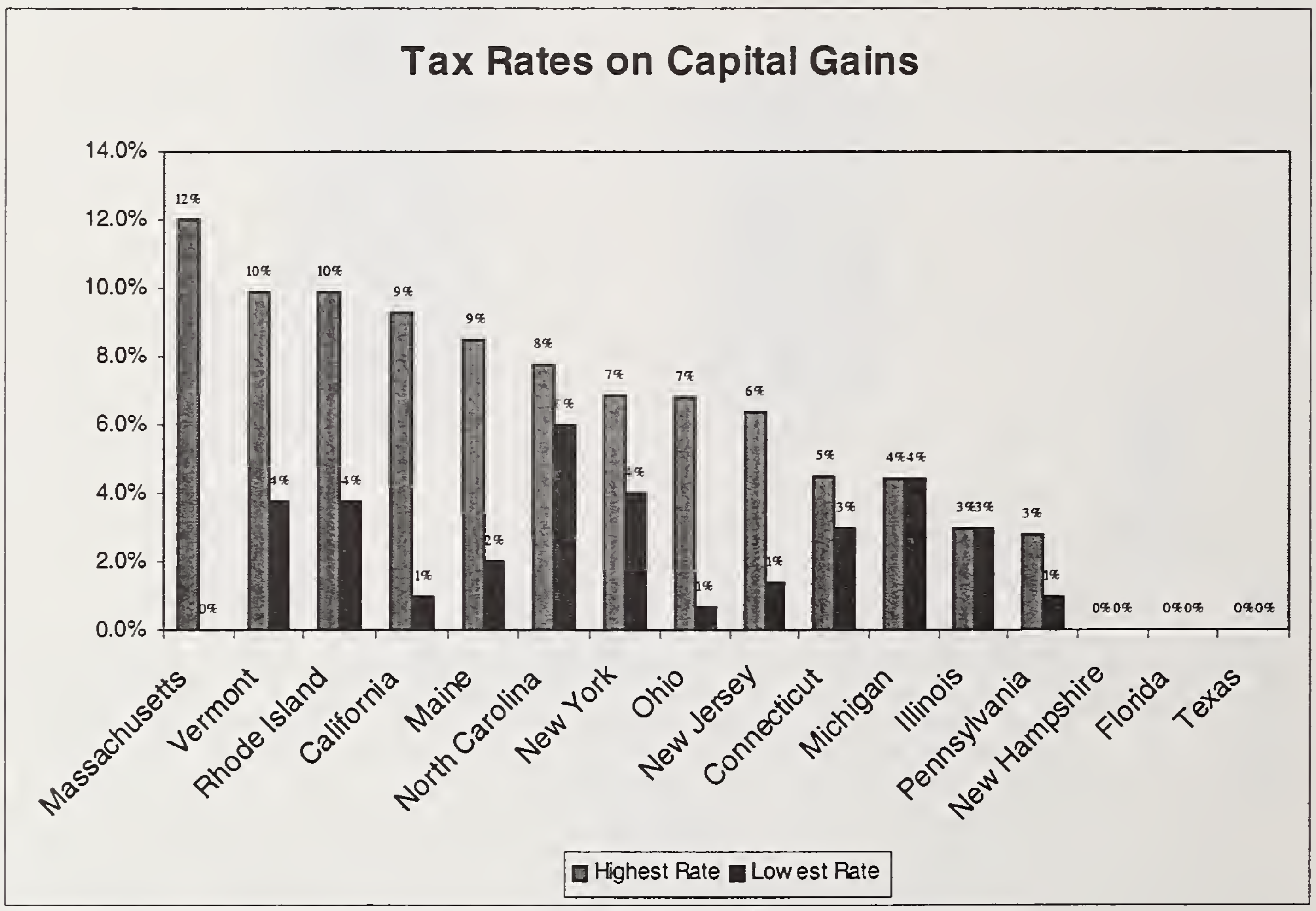
10 "Comparing Capital Mobility Across Provincial and National Borders" John F. Helliwell, Ross McKitrick

11 "Capital Gains Taxes and the Economy: A Retrospective Look" David Wyss, Standard & Poor's DRI

The large concentration of the investment and mutual fund firms in the Commonwealth also make the state more vulnerable to taxes on capital. Finally, the capital-intensive nature of Massachusetts's manufacturing (i.e. instruments) and services (healthcare) further increases the sensitivity of this state to capital deterrents.

State Competitiveness

Even with our recent reductions in the capital gains tax rate, Massachusetts still has higher taxes on capital gains and investment earnings than most of our competitors. Increasing them more will make the state less attractive to capital investment and punish Massachusetts workers and families. Reversing a tax reduction before it is fully implemented will also erode confidence in past and future Legislative overtures to the business community. **Just as the Commonwealth works to maintain a good bond rating, so too must it work to maintain consistency in its tax policy**. As Joshua Aizenman of Dartmouth points out, in the absence of a consistent tax policy, "the economy is characterized by under-investment."[12]



Source: Federation of Tax Administrators, National Center for Policy Analysis

Conclusion

Increases in capital gains taxes rarely increase revenues. Yet they do punish patient investment, which is the only sure method of raising productivity and wages. The Legislature's proposal to renege on the capital gains tax reduction passed two years ago will discourage investment, depress wages, and possibly even reduce state revenues.

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[12] "New Activities, the Welfare Cost of Uncertainty and Investment Policies" Joshua Aizenman